Office of Chief Counsel
Internal Revenue Service

memorandum

CC:SER:NCS:GBO:TL-N-3039-99
JGramling

date: JUN 17 1999

to: District Director, North-South Carolina
Attn: District Taxpayer Advocate

from: District Counsel
North-South Carolina

---

subject: **Request for Technical Assistance**
Inclusion in income of payments
State income tax refunds to retirees
Settlement of class action suit

DISCLOSURE STATEMENT

This advice contains confidential information which may be subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

INTRODUCTION

This is in response to your memorandum dated May 4, 1999, requesting technical assistance with respect to an inquiry from [redacted], [redacted], [redacted] submitted at the April 29, 1999, Problem Solving Day. We request that you not provide [redacted] with a copy of this memorandum.

10827

ISSUE

Whether the refund of a portion of previously paid North Carolina income taxes on government retirement income, including principal and interest, to a government retiree is includable in the taxpayer's income in the year of recovery.

CONCLUSION

To the extent the deduction of the state income taxes resulted in a tax benefit during a prior year, the refund should be included in income in the year of receipt. Accordingly, a calculation of the portion of the refund to be included in taxable income in the year of recovery is required for any taxpayer whose federal income tax liability in a prior year was reduced due to a reported itemized deduction for state income tax. Interest on the refund is includable in income. The Service should be prepared to provide assistance to taxpayers in calculating the amounts of the refunds includable in income, if any.

FACTS

Prior to 1989, the State of North Carolina exempted from state income taxation retirement benefits of state and local (but not federal) retirees. In 1989, the United States Supreme Court struck down as unconstitutional a state statute which provided for disparate treatment of state and federal pensioners. Davis v. Michigan Dep't of the Treasury, 489 U.S. 803 (1989). Subsequently, North Carolina lawmakers amended the North Carolina statute to tax both state and federal pensions, with up to a $4,000.00 exemption for both. See N.C. Gen. Stat. § 105-134.6(b)(6). Since that time, several state and federal retirees objected to the taxation of the pension proceeds and brought various suits disputing the 1989 amendment to the statute, requesting refunds and interest. In May of 1998, the North Carolina Supreme Court ruled that the 1989 act unconstitutionally taxed state and local class members. Bailey v. North Carolina, 500 S.E.2d 54 (1998). Subsequently, a global settlement was negotiated, which will result in the issuance of refunds and interest to approximately 250,000 North Carolina retirees. As a result of the Court ruling and the settlement, the State will no longer tax the retirement income of persons vested prior to August 12, 1989; retrospectively, certain taxpayers will receive refunds of part of the state income taxes they paid on their government retirement income, along with accrued interest, for the taxable years 1989 through 1997.[1]

DISCUSSION AND ANALYSIS

As a general rule, a taxpayer must include in income in the year received, amounts deducted in a prior year to the extent that the deduction in the prior year resulted in a tax benefit, i.e., reduced the taxpayer's tax liability in that year. I.R.C. § 111. Income tax refunds are included in the sweep of section 111. See Treas. Reg. § 1.111-1(a).

Furthermore, where a taxpayer pays state income tax under a law subsequently deemed to be unconstitutional, a refund of taxes paid under that law is included in income if the taxes were deducted on the federal income tax return and the deductions resulted in a tax benefit. See Nash v. Commissioner, 88 F.2d 477 (7th Cir. 1937).

It is our understanding that the refunds to be made will be for the taxable years 1989 through 1997. Retirees who did not deduct the state income taxes paid during those years do not have to include the refunds of the taxes in income in the year of recovery. See Smith v. Commissioner, T.C. Memo. 1982-546. (This exclusion does not apply to interest, which is includable in income under the provisions of section 61).

On the other hand, the recovery of any refund should be included in income to the extent that a prior year's deduction of state income tax paid reduced the retiree's tax in that year. Since the refunds span nine years, the amounts of the refunds attributable to each year will have to be calculated. The computation of the refund amount includable in each retiree's income may be further complicated if the retiree's itemized deductions were limited under the provisions of section 68(a).

---

[1] State and local government retirees are expected to receive approximately 95 percent of state income taxes paid, plus interest, prior to deductions for administrative costs, attorneys' fees and expenses, while federal retirees are expected to receive approximately 70 percent, plus interest. The difference in the state and local retirees' recovery as compared with the federal retirees' recovery is due to the uncertainty of the federal retirees' recovery with respect to unresolved issues associated therewith. Order Approving Class Action Settlement, filed October 9, 1998, pp. 3 and 5.

In summary, refunds to be distributed to retirees are taxable to the extent any deductions for state income taxes created tax benefits (reduced the retirees' tax liabilities) in a prior year. Inasmuch as there may be difficulties for some retirees in determining whether their individual refunds are includable in income, and if so, what amounts, the Service should be prepared to offer its assistance to the retirees in computing amounts of the refunds to be included in taxable income.

We have spoken with Mary Beth Hahn, the Fed/State Coordinator for Virginia, who stated that the State of Virginia devised a Form 1099 for the retirees receiving refunds; the Forms 1099 informed each retiree whether and to what extent the refund was includable in the retiree's federal income. Harry Martin, the North Carolina Fed/State Coordinator has advised that he will contact the North Carolina Department of Revenue with respect to the State's plans to advise the retirees of the taxability of the refunds they receive. In the meantime, I am enclosing copies of materials which we received from our offices in Virginia and Arizona.

If you have any questions with respect to this matter, please contact Jeanne Gramling at extension 2229.

/s/ James E. Gray
JAMES E. GRAY
Acting District Counsel

Enclosures:
As stated